



RELEASED COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

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B-198581

APRIL 28, 1980

✓ The Honorable Paul S. Sarbanes  
Chairman, Subcommittee on Securities  
Committee on Banking, Housing, and  
Urban Affairs  
United States Senate

SEN00707



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Dear Mr. Chairman:

Subject: [Preliminary Information on Misuse of the  
Private Placement Exemption--Section 4(2)  
of the Securities Act of 1933] (FGMSD-80-55)

On April 23, 1980, your office requested information on the results of our ongoing review of the use of an exemption under the Securities Act of 1933 which permits the sale of privately placed securities without registration with the Securities and Exchange Commission. You asked for this information by April 28, 1980, so that our findings can be considered during hearings on venture capital formation. Although our review is not yet completed, we are able to provide the following preliminary information. We expect to issue a more detailed report on misuse of the private placement exemption at a later date.

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THE PRIVATE PLACEMENT EXEMPTION

The Securities Act of 1933 imposes disclosure and anti-fraud requirements on securities issuers. A securities issue must be registered with the Securities and Exchange Commission unless the issue is exempt from registration. This requirement is intended to insure "full and fair disclosure" in securities sales to enable investors to make informed investment decisions.

One such exemption, in section 4(2) of the act, is for issues which are sold to investors in private transactions and is commonly called the private placement exemption. Section 4(2) states that registration requirements shall not apply to "transactions by an issuer not involving any public offering."

MISUSE OF THE PRIVATE PLACEMENT EXEMPTION

During the 3 years ending September 30, 1978, the Commission investigated 142 cases involving misuse of the

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private placement exemption. According to Commission investigative files, investors have been defrauded out of hundreds of millions of dollars by being sold securities which were improperly represented as privately placed issues. The investors were not given the accurate and complete information which would have been available to them had the securities been registered as public offerings.

For example, promoters raised \$10.3 million selling securities in businesses to construct apartment buildings. They overstated to investors their experience, their financial strength, and the profitability of their previous real estate businesses. They did not disclose that the businesses were in serious financial difficulty, that a prominent businessman who was held out to be an investor was in fact one of the promoters, or that funds had been diverted to other projects and used to pay off unrelated debts. By the time the scheme collapsed, investors had been defrauded out of \$9 million.

Many of the persons who bought these securities and lost their savings were novice investors. They did not have the experience to be investing in unregistered securities and some, because of advanced age, limited earning power, or ill health, were in no position to recover from the losses incurred.

While the Commission's 142 investigations showed that the general public was defrauded, the investigations did not indicate that the purchase of fraudulent securities was also a problem for institutional investors, such as insurance companies. It should be noted that businesses have raised billions of dollars by legitimately selling unregistered securities under the private placement exemption.

#### INVESTORS SUFFERED SERIOUS LOSSES

The Commission's investigative files showed that for 95 of the 142 investigations, 30,000 investors were defrauded of over \$255 million. In the remaining 47 investigations, inadequate records prevented the Commission from estimating the losses to the investing public.

In one of the cases examined, one man invested over \$30,000 to ensure a continuing income to help care for his brain-damaged child. He raised the money by selling his

home and was promised a 30 to 40 percent return on his investment. After finding he had been defrauded of his entire investment, he committed suicide. In another case, an investor who had worked for 30 years and whose recent salary was about \$12,500 lost his entire life's savings of more than \$45,000. He needed money because he was in ill health and could not work.

The losses disclosed by the Commission's investigations may be only the tip of the iceberg. In reply to our questionnaire which was designed to obtain state views on the Federal private placement exemption, state commissioners reported that investors had lost hundreds of millions of dollars by investing in fraudulent private placement schemes. Twenty-eight commissioners estimated that investors in their states were defrauded out of \$330 million to \$350 million in 1978 alone. Forty-three state commissioners said that there appeared to be fraud in 462 of the 528 investigations they conducted in 1978 involving the private placement exemption.

#### PRELIMINARY OBSERVATIONS

Misuse of the exemption is difficult to control under any circumstance, but the Commission is hampered in its enforcement efforts. We have made the following preliminary observations as to why serious misuses of the exemption have occurred:

- Use of the exemption has been a continuing source of uncertainty.
- The Commission does not always receive notification of exemption use.
- The Commission does not have timely access to promotional literature and other information.

#### Use of the Exemption Has Been a Continuing Source of Uncertainty

There has been much uncertainty over the past 45 years as to what section 4(2) means. In 1953, the Supreme Court found that use of the exemption hinged on investor protection. The Court held that privately placed securities could be sold only to persons who could fend for themselves--commonly called sophisticated investors--and that investors had to be given access to the kind of information which registration would

have disclosed. The Supreme Court did not define these requirements and subsequent attempts to interpret their requirements only caused further uncertainty. An American Bar Association committee concluded in 1975 that it was difficult, if not impossible, to determine the proper use of the private placement exemption.

The Commission attempted to reduce the uncertainty by issuing rule 146. This rule details requirements which issuers must meet to qualify for a private placement. However, on the basis of the Commission's position that it does not have the authority to issue binding rules governing use of the section 4(2) exemption, use of rule 146 is optional. An issuer can claim the exemption under section 4(2). Promoters take advantage of this loophole and the ambiguity of the act in selling fraudulent securities.

Commission Does Not Always Receive  
Notification of Exemption Use

Issuers are not required to give notice when they use the section 4(2) exemption. Rule 146 requires prior notice to the Commission, but reliance on this is optional. Thus a promoter wishing to defraud investors through a private placement can merely claim the sale is exempt under section 4(2) without providing prior notification. As a result, enforcement is reactive because the Commission is usually unaware of use of the exemption until it receives a complaint or other indication that abuses are occurring.

Commission files show that many of the fraudulent schemes in the 142 cases examined operated for a number of years. For example, a business scheme, by which investors were defrauded of at least \$5 million, was inadvertently uncovered after operating for 5 years.

If issuers were required to give notice as a condition of the section 4(2) exemption, the Commission would have a tool necessary to monitor use of the exemption. For example, in 68 of the Commission's 142 investigations involving misuse of the exemption, the promoters had previously been subject to a Federal or state securities investigation.

Under such a requirement, if notification was not given by the issuer and the Commission learned of the sale through another source, they could immediately halt the sale. Our

questionnaire revealed that 27 state securities commissioners felt the lack of notification facilitated the sale of unregistered securities in connection with fraudulent schemes.

We do not envision notification as a burden to issuers. They would not need to furnish the kind of information required under registration, but would merely advise the Commission that they are selling exempt securities and provide information identifying the company, its key officials, and the nature of the securities being offered. The one-time filing of a single sheet form would be sufficient.

Commission Does Not Have  
Timely Access to Information

The Commission is also hampered in its enforcement capability because it does not have authority to readily obtain issuers' promotional literature and other information which could indicate misuse of the section 4(2) exemption. This enables promoters to continue to sell fraudulent securities and to further divert investors' money.

Even though private placements are exempt from registration, it is intended that investors have access to the same kind of information that registration would provide. Commission experts can identify inconsistencies, misstatements, and inadequate disclosure by reviewing promotional literature. For example, in one case the promoters fraudulently obtained \$20 million through a coal mining scheme. Had Commission experts been able to review sales literature on a timely basis, they may have been able to stop the promotion in its early stages and protect investors.

The Commission's staff may be able to obtain evidence of violations from other sources. However, this can require many months of investigation by the staff. During this period, use of the exemption is not suspended, and more persons may be drawn into fraudulent business schemes.

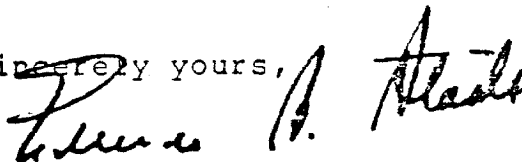
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As indicated above, this is a complex issue. We are considering what options we can present to the Congress for its consideration in deciding what changes could be made in this area to better protect the investor without inhibiting the legitimate raising of capital through the private placement exemption.

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In view of the urgent need for this information, we did not obtain official comments from the Commission on this report. As arranged with your office, copies of this report will be sent to other interested parties and to the Commission tomorrow.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "Thomas A. Heath". The signature is written in a cursive style with a large initial "T" and a distinct "A".

Comptroller General  
of the United States